

**Testimony of  
Curt L. Hébert, Jr., Commissioner  
before the  
Senate Committee on Energy and Natural Resources**

**April 27, 2000**

**Overview**

I thank the Committee for the honor of testifying here this morning on the various electricity restructuring bills pending before you. In my opinion, Congress should adopt the principle that legislation should remove obstacles to the natural evolution of the industry. FERC does not need more jurisdiction; indeed, we need less. Right now, the generation and transmission businesses are moving in opposite directions. On the wholesale level, FERC has deregulated prices for generation because of the proliferation of independent power and technology that allows plants to come on line in 18 months or so. Transmission, on the other hand, will have to remain regulated for the foreseeable future. Transmission must become a stand-alone business and respond to the market. It must do so, however, within the framework of regulation, though a new form.

Historically, regulation reigned in economic interest for the sake of the public interest. Most people agree that approach failed. From now on, regulation must align economic interest with the public interest. Together, Congress and FERC must act in a way that gives the new model a chance to succeed. What may have worked in the Depression Era no longer works in the Internet Age. In our respective spheres, Congress and the FERC must clear out the underbrush to allow new growth to take over.

FERC and the states can, and, under the right leadership, will remove most regulatory impediments toward efficiency in electricity. Recently, FERC issued Order No. 2000, which flatly states that restructuring will succeed only if transmission becomes a stand-alone business. By unanimous vote, we applied what an economist called a form of performance-based regulation." Rather than write rules and mandate outcomes, Order No. 2000 laid out a business plan – 12 goals, four characteristics and eight functions, for regional transmission organizations to meet.

The Commission opened the door to rate reforms for RTO's to propose as necessary to make the transmission business viable on a stand-alone basis. The Order listed eight, from temporary rate moratoria to performance-based rates. Rather than look at costs, we will focus on value to the customer, as businesses do in the free market. FERC has jurisdiction under current law to approve each of them and many others that RTO's can justify.

People know that about half the States have passed laws opening their retail markets to increased customer choice, to one degree or another. Less well known to most people, some have gone farther. States, such as Wisconsin, have passed laws that require utilities to separate transmission into a separate business. In the case of Wisconsin, the Legislature chose a for-profit company. With transmission as a separate business, FERC has jurisdiction over the wires under current law.

With the right leadership FERC will move forward toward effective restructuring. Incentives and performance-based rates will unleash entrepreneurial initiative. By

aligning the public interest with economic interest, doing the right thing for customers will also result in better earnings for shareholders. Transmission companies will establish a business plan in consultation with customers. Companies that meet or exceed the goals in the business plan will earn profits for shareholders. Those that fail will take the risk, and, ultimately, as in any market, will sell their facilities to more efficient entities. All that can happen under FERC's current jurisdiction, without one word of new legislation.

FERC can go only so far, however. Laws enacted as far back as the Depression and as recently as the Carter Administration, that made sense in their time, now act as a drag on restructuring. These laws have the ironic effect of causing harm to the very consumer they were supposed to protect. In addition, unintended consequences of tax law encrust the *status quo*, at a time that cries out for change. More than the incentives of Order No. 2000, Federal Marketing Agencies, including Bonneville Power Administration and the Tennessee Valley Authority, need legislation to authorize them to become or join Regional Transmission Organizations. Participants in the discussions in the Northwest agree that Congress should act, whether the RTO takes the form of a for-profit transmission company or a not-for-profit system operator.

Worse than doing nothing, Congress can harm the process of restructuring by taking the wrong road and passing unnecessary legislation or laws that point toward more regulation.

## **The Need for Legislation**

### *Repeal Outdated Laws*

#### 1. PUHCA

The Public Utility Holding Company Act, dating from the Depression, and the Public Utility Regulatory Policies Act, dating from the Carter Administration, act as serious brakes on restructuring. The Holding Company Act requires registered companies to submit to onerous regulation by the Securities and Exchange Commission, including seeking permission for moves that companies make in the ordinary course of their business. Pointedly, the Act exempts utilities operating within one state from registration. The Act also subjects holding companies to requirements that they operate an “integrated” and contiguous system.

Tied to a world in which state commissions, to the extent they existed, operated in isolation, Federal securities laws had just been enacted, power could flow over short distances and designed to combat the effects of stock manipulation during the 1920's, it has outlived its usefulness. As information technology has improved and investors have become more sophisticated, utilities must grow larger and operate beyond the boundaries of single states. Enforcement of securities regulation has eliminated the abuses of the 1920's, in all areas of the stock market. For that reason alone, Congress should repeal the law.

More important, the Holding Company Act has perverse effects. Because of the provisions for foreign utilities, the Act causes foreign companies to buy here and U.S.

companies to invest overseas. Investment in and from overseas help integrate the world economy. The investment should result from economics, not the vestige of a law that outlived its time.

## 2. PURPA

While not as old as the Holding Company Act, the Public Utility Regulatory Policies Act needs repeal. PURPA, as we call it, forces utilities to buy from alternate energy sources at high prices. Congress passed it at a time when people thought we needed to lessen our dependence on oil for electric generation and that subsidies would help accomplish that result. Now, 22 years later, when we want to bring prices down and when developers can build gas-fired generators in about 18 months and distributed generation lies on the horizon, subsidizing certain types of generation makes no sense. Moreover, experience at FERC shows that the alternate sources PURPA envisioned -- those exclude gas -- have either been fully exploited or (as in the case of municipal waste) have proven infeasible. Several proposals before the Committee this morning would repeal both laws and I support that.

## 3. Section 203 of the Federal Power Act

The Federal Power Act gives FERC the authority to review electric mergers. FERC has no expertise in the area. FERC enacted a Merger Policy Statement that ignores contemporary economics, such as the Department of Justice and Federal Trade Commission's practices in making mergers difficult. When utilities should consolidate with neighbors to reflect the growth in the economy, FERC considers those moves anti-

competitive. Also, FERC uses mergers to further policy goals that it has no authority directly to order.

I offer the *AEP-CSW* merger case (90 FERC ¶ 61,242 (2000)) as an example. My dissent pointed to the fact that, without any factual support, the majority overruled the findings of an Administrative Law Judge who relied on testimony of a former Chief Economist of the Antitrust Division and the economist at FERC who had a large hand in our merger policy. In addition, the Department of Justice's International Advisory Committee recommended repealing FERC's merger authority. Congress should pass a law to that effect. Let the Antitrust Division and the Federal Trade Commission, the expert antitrust agencies, review mergers in the electric industry, as they do for the reset of the economy (except for communications and railroads).

### *Public Power*

Over the course of the 20th Century, Congress helped create Federal “public power” marketing agencies, such as the Bonneville Power Administration and the Tennessee Valley Authority. During the 1930's, both helped bring the blessings of electricity to remote areas that the power companies could or would not serve. In addition, thinkers at that time, including Franklin D. Roosevelt, envisioned public agencies as a competitive spur to private utilities reducing their costs.

On the first objective, the country can proudly say, "Mission accomplished." We, in this country, have the finest and most extensive electric system in the world. The second proved disappointing. Both TVA, and to a lesser extent, Bonneville, became

debt-laden bureaucracies. To its credit, Bonneville has reformed, but remains burdened with bad debt from nuclear plants. Bonneville has continuing disputes with utilities in the Northwest that claim it uses its transmission (80% of the region) to favor its own generation. The stakeholders in the Northwest, according to my understanding, prefer to separate Bonneville's transmission from generation and to form a for-profit entity, even as a Government corporation. Bonneville has already split its transmission into a separate business line. It needs a separate Board of Directors and a new mandate. This will alleviate preference concerns while not harming the already low rate structure in the Bonneville region.

TVA remains a great problem. Forces in Bonneville want to separate transmission from generation into a stand-alone for-profit business. TVA's transmission has value that, if sold, would help retire its huge debt to the Treasury. While Order No. 2000 created the atmosphere to a separate transmission business, Bonneville and TVA may not legally change. Congress must pass a law. I could support, as a first step, the creation of a for-profit government transmission corporation in the Northwest and another in the Southeast. The program would resemble Conrail, the for-profit stand-alone Federal freight railroad for the Northeast that the Government eventually sold for a good return. States can change their laws regarding locally owned public power.

As a private businesses, Bonneville and TVA would become subject to Order No. 2000. Given the incentives in the Rule, the Federal transmission owners will form into regional transmission organizations. State and local Legislatures have the authority to

allow municipal utilities (and in some cases, cooperatives) to join RTO's. To the extent, state constitutions require amendment, the individual State can use its own procedures to accomplish the goal. I emphasize that, given the economic evolution of the industry and the incentives of Order No. 2000, States will see it in their interest to act. As with retail competition, where the States took the lead, Congress should stay its hand.

Congress has a large role in tax policy. While this area lies outside my expertise, I have heard from many trying to form for-profit transmission companies that spinning off or selling assets creates a tax liability. Turning over operation without ownership does not. Therefore, utilities would find it more difficult to create for-profit transmission companies. Since Congress must deal with the thorny issue of tax exemption for public facilities anyway, I have every confidence that legislation will solve this tax issue also.

### **What Congress Need Or Should Not Do**

I have often said that Alfred Kahn described restructuring when he said that competition is a substitute for regulation and regulation is a substitute for competition. To me, we must choose which direction to move in. We must move away from regulation and toward competition. That requires, in some instances, a new way of thinking. As I discuss next, some issues the market will address that previously regulation addressed. In other instances, we must let go altogether and not fear the unknown.



*Reliability*

We hear great clamor over possible reliability problems in a restructured market. Many fear for this summer. I think this a legitimate issue for discussion. I think, however, that the solution lies in the market, not in creating an organization, under FERC oversight, with FERC having last-resort authority to impose standards on the industry.

I testified on this question before the House Commerce Committee's Subcommittee on Energy and Power. I said then that I oppose FERC having authority to establish reliability standards. I also think that the current system, involving private regional reliability councils establishing the standards needs reform. I favor injecting reliability standards in the performance based rate plans I advocate for utilities. In particular, each plan for each Regional Transmission Organization would contain a target for reliable performance. I envision interested parties negotiating the issue, along with the other factors in the plan for presentation to FERC. Each RTO's earnings would rise or fall on how well it does.

My suggestion then is to create a climate in which that occurs in transmission. Specifically, tie profits to performance – safe performance and an adequate number of transactions. Give transmission companies business plans to meet. Favorable earnings result from good results, losses from poor management. Clearly, we don't need legislation to do that. FERC has the authority to institute performance based rates. We did it in Mississippi. The Public Service Commission put three criteria into the final plans. Two of them fall directly under the category of reliability, and one indirectly.

Earnings depended on the number and duration of interruptions, customer satisfaction (using actual complaints) and price into which we factored sales transactions. The companies figured out how to set and meet reserve margins, safety standards and capacity goals. We aligned the private economic interest with the public interest. FERC can do that now.

Lastly, I note that, in other industries, such as electric appliances, the market participants established an organization, Underwriter's Laboratory to endorse the safety and reliability of their products. RTO's, especially for-profit companies, have the same incentive to form an organization that will establish proper standards. I will illustrate the problem with a governmental mandate. At the most recent FERC public meeting, we considered in the case *New York Reliability Council*, whether to allow the New York Council to reduce its reserve margin from 22 to 18 percent. We did. It turns out, however, that the study on which the New York Council relied said that 12 percent would ensure smooth operation, but at maximum, 17 percent would do the job. The New York Council threw in 1 percent for good measure! In economic terms, the New York Council either withheld capacity that belongs on the market or wasted money. A private, for-profit transmission company would have relied on hedging or financial means in case 12 or 17 percent proved too low.

On this issue I think reasonable people can discuss various alternatives.

### *Market Power Authority*

Another area in which we hear much advocacy relates to giving FERC more authority over "market power." Mind you, the antitrust laws would still apply. FERC would have regulatory power in addition to the Antitrust Division and the Federal Trade Commission. Legislation here I consider wrong, in the sense that it moves in the direction of regulation and away from competition. Exercising market power, in the true sense of the term, violates the antitrust laws. What more can FERC guard against? Proponents give evasive answers. My experience at FERC, however, gives me a clue.

In a number of cases involving price caps for independent system operators in California and New England, the cry of market power arose every time the price rose to a level that the ISO did not like. Without proof of monopoly or collusion, regulators cried market power, when, in fact, prices rose during peak season, when demand rose. The pleadings say that market power occurs every time a price rises above marginal (operating) cost. I called this "capitalism at its best." I also pointed out that prices in the flowers market rise just before February 14, without anyone calling for controls.

Levity aside, legislation here poses a danger. Price caps mask mistakes in market rules or ISO procedures and make reform difficult. When regulators depend on a crutch, they need not undergo painful rehabilitation that would, in the end, allow them maximum mobility. In addition, high prices bring new supplies or decreased demand during peak times. Holding prices at operating costs all the time does not allow sellers to recover

overhead, let alone earn a profit. Markets require giving sellers the opportunity to earn a profit.

*Interconnection Policy*

Lately, we have heard that Congress must give FERC the mandate of writing rules to allow generators to connect to the grid. Not only that, but a DOE-led task force calls for uniform provisions as well. I find this a waste of time and money. An RTO, especially a for-profit, stand-alone transmission company, would welcome interconnection from generators, as railroads, ships and trucks (and airlines) welcome freight. The problem the DOE addresses results from an alleged bias toward generation. If we separate transmission from generation, we remove the bias.

More important, at a time when FERC and the industry are engaged in collaboration to form stand-alone transmission companies, we must keep our eyes on the forest and off the trees. As with all things, the market knows better and can adapt better than regulators to changes. While Franklin D. Roosevelt advocated trying something else when the original solution fails, how many of us in Government, without pressure of the laws of economics, have the courage to live by his credo? Very few, I am afraid.

I will gladly answer your questions.